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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products	)))	Docket No. RM2017-3

INITIAL COMMENTS OF THE
AMERICAN CATALOG MAILERS ASSOCIATION (ACMA)

(February 3, 2020)

Pursuant to Commission Order No. 5337, "Revised Notice of Proposed Rulemaking," December 5, 2019, ACMA is pleased to submit these comments.

I. Introduction.

Catalogers depend on the existence of a nationwide Postal Service, as do their employees, their suppliers, and their customers, who exist in every state. They need a low-cost Postal system with reasonable rates. Such a system requires volume. If volume continues to decline, and a Universal Service Obligation with high service standards is maintained, the costs will become increasingly prohibitive and the viability of the network will collapse. This will be the result of simple market forces, not of mailers that chose failure.

Certainly since 2007, and by some accounts for a much longer period, rates have not deviated much from the rate of inflation. Even this has led to postage being a substantially higher proportion of mailer costs than it was even a decade ago. That this proportion is creeping so high should be heard as the call of a clarion. ACMA believes we are at a point where rate increases of the magnitude contemplated in this docket, if implemented by the Postal Service, will cause volume declines and economic dislocations that go well beyond those suggested by the official elasticity estimates. The econometrics that led to these estimates cannot deal with turning points or thresholds, and have difficulty predicting the future. ACMA members do not depend on elasticity estimates to decide how much to mail—they have instead the models that determine the volumes the econometrics examines. Econometrics attempts to infer from resulting patterns; it is mail originators who know what is going on and who must make investment decisions.

Congress is the entity that burdened the Postal Service with liabilities that it could not bear. But for the burden Congress placed, the Postal Service might be contemplating rate increases, but they would be small. Also, Congress failed to give the Postal Service the wherewithal to make changes that might improve its finances, and it, and others, continue to oppose needed changes. If Congress does not fix the current situation, neither Congress nor the American people will like the outcome. Market forces are real things; they can be terrible things. The cost of a collapse, often called a death spiral, will be tremendous.

ACMA is a signatory to other comments in this proceeding. What we do here is more limited: First, we make four short, general observations that we believe point to important matters. Second, we provide comments on the Commission's density analysis.

II. Four Factors to Consider.

1. ACMA explained in its initial comments in Docket No. ACR2019, January 30, 2020, that it would be detrimental to the viability of the overall Postal system to continue to force higher and higher rates on mail in the Marketing Mail class that is less dense than the arbitrary thresholds of the ECR categories. We incorporate those comments by reference.

2. ACMA explained in the same comments that serious questions exist about the validity of many of the costs being reported. It may take a difficult and long proceeding to change the costing procedures, and the outcome of such a proceeding could be a surprise, but when serious questions exist, it is unreasonable to stand on those costs and make changes of import that are likely to have far-reaching, currently unquantifiable, consequences.

3. ACMA continues to believe that the Performance Based Authority, as proposed by the Commission, is misguided and will not help. The law may allow an option to use cap authority at a time when retained earnings are available, but it does not authorize beyond-cap increases for the purpose of generating such earnings. Also, the TFP is far too weak an indicator to guide a cap adjustment. Further, the appropriate way to obtain investment funds, when an ROI exists, is to borrow. Congress and the Postal Service could arrange this. When the aim of the investments is to help avoid rate increases, imposing rate increases to fund the investments is misguided.

4. ACMA has explained that a way to handle the Retirement Obligations needs to be arranged by Congress in such a way that a viable Postal system can be maintained. But if rates *are* increased for this purpose, ACMA believes they should be

in the nature of a surcharge that can be removed when Congress acts. It is not in order for Retirement rates to be made part of the rate base upon which CPI adjustments are made. That is, the existence of a Retirement surcharge should not be a cause for the CPI increase to be larger. The issue, of course, is compounding. And it should be explained to Congress that a surcharge going on and off is disruptive. Part of the disruption is that mailers leaving the system, due to a surcharge, will *not* likely return.

III. The Commission's Density Authority Is Illogically Conceived and Without Foundation.

The theory underlying the Commission's density adjustment is deathly simple. If a piece of mail has a cost of 6¢ and a rate of 10¢, then it makes a contribution of 4¢, which is 40% of the 10¢ of revenue it brings. This 40% is commonly called the markup fraction (MUF).[1] A MUF exists for pieces of mail and for aggregations of mail. Thus a MUF exists for market-dominant mail, competitive mail, and for the totality of mail.

If the volume of mail declines 10%, and the mix is unchanged, the revenue will decline 10%. But, since costs will decline *6%* (in this example), the Postal Service's net income will decline only by an amount equal to the MUF times the revenue decline. Therefore, if the revenue declines by $10 million (due to a volume decline), and if the MUF is 40%, then the net income will decline by 40% (the MUF) times $10 million (the revenue decline). A cap adjustment can make up for the reduction in net income.

It is important to note that all this is *ceteris paribus*, relating to an experiment nature never performs. One of the *ceteri* is that the mix of mail remain unchanged, an

[1] In common retail parlance, a 50% markup is usually interpreted to mean that the price is 1.5 times the cost to the retailer. At this markup, an item costing $10 would be priced at $15. The markup fraction (MUF) would be 5/15 ≅ 33.3%.

important assumption that warrants attention. Another is that the Postal Service does nothing to improve the control of costs, which is supposed to be a principal benefit of a cap system. The Commission did not examine the *ceteri*, but went on anyhow.

The first term in the Commission's density-adjustment formula, however, is not a MUF, which would be a contribution divided by a revenue. Rather, the first term is specified as total institutional cost divided by total cost. This term exists for the overall Postal Service but does not exist for any disaggregation. The Commission calls this term the "institutional cost ratio." There is no logic or other justification for using a ratio with this definition, and the Commission suggests none. Until some justification is provided, and we believe it is clear that none exists, the ratio cannot be used.

The Commission links its institutional cost ratio (the first term in its equation) to the percent change in density (the second term in its equation). The percent change in density is calculated for the market-dominant products as a group and for all products as a group. The Commission does not explain why it does not calculate the percent change in density for the competitive products as a group.

Another problem is apparent: Why would the Commission link a ratio for the *overall* Postal Service to a percent change in density for a *subgroup* of products, in this case for the market-dominant products? This linkage is a mismatch on its face, and the Commission provides no justification for it. The Commission does, however, say that the percent change in density for all products is lower than the percent change for the market-dominant products, so it is protecting from cross-subsidy by using the lower one. But if there is no sense associated with a change for a *subgroup*, then the "protection" is illusory.

The Commission *does* say that the institutional cost is used because the level of it is fixed with respect to volume changes. The notion seems to be that one pot of costs, perhaps some accounting categories, can be identified and classified as variable and that another pot of costs can be identified and classified as fixed. But such a notion does not comport with the basic principles of costing. The level of variable cost is defined and estimated on the *behavior* of the costs at the margin, i.e., on how the level of the costs change with small volume changes. It is *not* the level of a pot of costs; it is a reflection of behavior. Then the institutional cost is defined as the total cost minus the variable (or attributable) cost. It is a residual defined on a reflection of behavior. It is *not* a pot of costs that is fixed. Whether some accounting categories exist that do not change with volume is irrelevant to the principles of costing and to the concept of institutional cost.[2]

Once the Commission identifies a cost amount as institutional and fixed, it reasons that this cost will be the same in the next year even though the volume changes. This notion too does not comport with the basic principles of costing. Variable cost is estimated in a base year based on behavior, and institutional cost is the residual. In the next year, when the volume is different and the Postal Service has adjusted the network, a new level of variable cost is estimated based on behavior in the next year, and a new residual is calculated. There is no reason why the level of the institutional cost, or even the percent-variability of the costs, in the next year should be the same as those in the base year. To assume either is unchanged in the next year is to assume away the need for an analysis and to apply an answer that is almost certainly

[2] Generally, references to “institutional cost” should be in the singular, because it is a level, not, as explained in the text, a pot or group of costs that has a characteristic of fixity.

wrong. As stated above, the institutional cost is not a pot of costs that are fixed. In fact, in the face of volume declines, as well as in the face of technological change, system improvement, and network rationalization, one would hope that the institutional cost in the next year is lower than in the base year. And if this is not the case, questions need to be asked about Postal Service performance.

The institutional cost ratio used by the Commission is the ratio in the *next* year, not the base year. This raises another problem that is not discussed: As the Postal Service moves from a base year to a next year, particularly when volume is declining, it should be tightening the system and adjusting its network. If it fails to do this, and the costs in the next year are higher than they should be, the Commission's use of a ratio for the next year approves the Service's failure and gives it money to cover it. The incentives here are the opposite of what they should be. If the Commission proceeds with a density adjustment, the incentive provided should be improved.

The Commission defines density as the volume per delivery point. Since the costs used are accumulated over a year, it would seem that an average number of delivery points should be used. It appears, however, that the number of points at the end of the year is used. This may not much affect the percentage change in density from one year to the next, but it should be discussed. Consistency in the composition of numbers can be important.

For market-dominant products as a group, from FY 2017 to FY 2018, the volume decreased 2.528% and the number of delivery points increased 0.911%. In 2017, the density was 1,051.43 pieces per stop per year[3] and in 2018 was 1,015.60. The change

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[3] This 2017 density is equivalent to about 3.47 pieces per delivery point per delivery day.

in density was -3.408%. For all products as a group, the two densities, in the same order, were 1,088.59 and 1,056.47, for a change of -2.951%. The Commission does not consider corresponding figures for the competitive products as a group.

The Commission treats density as a "cost driver," a term used often in Postal costing. However, because (1) an infinite number of different combinations of percents change in volume and delivery points can lead to any given percent change in density and (2) the percent change in volume and the percent change in delivery points have different effects on net income, density does meet the qualifications for a cost driver and thus cannot be used. The Commission does not discuss this. Without a showing that a percent change in density has a certain effect on net income regardless of the composition of that percent change, the Commission's formula is without foundation. This would be true even if the first term were logically linked to the second term, a condition that is not met, as discussed above.

One way to think about the movement from a base year to a next year is to use the notion of an "anyhow volume," a notion critical in NSA proceedings and quite familiar to the Commission. One could ask what the next-year volume would have been if the number of delivery points had not changed; that is, "what is the anyhow volume?" The effect of this volume change could be analyzed. Then, as a second step, one could ask what the effect of new delivery points would be, with full recognition of the additional volume those points bring. The Commission did not discuss any of this.

The actual volume change would equal the anyhow volume change plus the new-point volume change. The Postal Service could develop information on the volume received by new points. If the points are for households being established, it is possible that this new volume is rather substantial. The point is, however, that no information on the effects of new points is available. It is not logical or right to simply assume that all important effects are estimable from a density variable, even if it is linked to a proper MUF. Assumptions need to be checked. The formula proposed by the Commission is without foundation.

Once an analysis of the delivery-point problem is undertaken, a central question would be the profitability of the new points to the Postal Service. Although it laments regularly that it has them, the Postal Service should be overjoyed at having the new points. Network industries with high fixed costs are almost always happy to have more customers. The new volume they bring adds to revenues, and that addition would be considerably larger than the additional costs.

As a practical matter, the profitability of the new volume is likely to be greater than that of the existing volume. Consider the following. Some of the new stops will be businesses, some of which will be engaged in e-commerce. Few of the additional stops are likely due to farms subdividing themselves. Rural carriers on mileage routes would not get paid more unless the route covers more miles, and the cost of rural carriers on paid-per-piece routes would increase only in proportion to volume. Rural routes are known to be lower cost than city routes and rural points have been growing more rapidly than city points. In areas of new development, the Postal Service is using cluster boxes, which are a low-cost way to achieve delivery. Also, cluster boxes are generally an improved way to handle parcels. Door delivery does not occur for new stops. Much of the growth is in multi-dwelling complexes, allowing mail to be delivered in mail rooms, sometimes by a mailroom attendant. When new housing is put into existing neighborhoods or between existing stops, the delivery can be accomplished with very little additional work. It is unlikely that new stops will cause new ZIP Codes or new post offices. As for mail moving across the country, it will be handled in the network that already exists—neither a sorting machine in Kansas nor a truck on the highway knows whether the pieces are going to new stops. And it seems likely that new stops will get more mail than old stops, as promotional letters and catalogs, as well as offers of assistance, are sent to growing families. Therefore, if a rough way were adopted to estimate this additional profitability, it would likely be an underestimate. Certainly the question should not be neglected.

It should also be noted that new delivery points give the Postal Service an opportunity to absorb the costs of expansion, thereby lowering unit costs, a principal hope of a price cap system. Until a way is found to estimate the profitability of new delivery points, we do not see it as possible to make an adjustment for their appearance.

IV. Conclusion.

It is unreasonable for increases in USPS productivity to be the cause of rate increases. That is not the way success is celebrated. It is likely unworkable at this point for rates to be increased to cover the group of retirement obligations—the volume losses could easily lead the system into a downward spiral. The density authority buys into routine behavior, apostasy to the cap. The assembly of formulas is à la Rube Goldberg. All this moves toward accept-the-costs ratemaking, anathema to the PAEA. This is certainly not what so many mailer interests fought for in the protracted run up to the passage of the PAEA. There are too many thorny and difficult questions, particularly with flat mail. The effects are too likely to cause irrevocable harm. Irrecoverable, preemptive action in a single dimension to cure a multifaceted problem—at the time of a new agency CEO, a new Board, a new Congress, and an important election—seems ill-considered from where these observers sit. ACMA feels this proposal will significantly upend jobs, destroy a user pay system, and make rural service increasingly costly given the powerful economic incentives this proposal will engender once urban and suburban mail migrates to alternative delivery, e-commerce, and other substitutes. More importantly, whole segments of the mailing industry may be mortally injured and may not be able to make the transition. ACMA has many members in this category. These casualties will forever remove the capability to conceive, market, and deliver highly desirable content to the mail, and will hurt consumer choice and convenience. The Congress and the Commission need to work toward a better solution.

Respectfully submitted,

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